

**TEACHERS' RETIREMENT  
SYSTEM OF THE  
STATE OF KENTUCKY**

**Financial Statements  
June 30, 2007**

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Board of Trustees  
Teachers' Retirement System of the State of Kentucky  
Frankfort, Kentucky

We have audited the accompanying statements of plan net assets of the Teachers' Retirement System of the State of Kentucky as of June 30, 2007 and 2006 and the related statements of changes in plan net assets for the years then ended. These component unit financial statements are the responsibility of the Teachers' Retirement System's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and Government Auditing Standards, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the general purpose financial statements referred to above present fairly, in all material respects, the plan net assets of the Teachers' Retirement System of the State of Kentucky, a component unit of the Commonwealth of Kentucky, at June 30, 2007 and 2006 and the changes in its plan net assets for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with Government Auditing Standards, we have also issued our report dated December 5, 2007 on our consideration of the Teachers' Retirement System of the State of Kentucky's internal control over financial reporting and our tests of its compliance with certain provisions of laws, regulations, contracts and grants. That report is an integral part of an audit performed in accordance with Government Auditing Standards and should be read in conjunction with this report in considering the results of our audit.

The Management's Discussion and Analysis on pages 3-6 are not a required part of the basic financial statements but is supplemental information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplemental information. However, we did not audit the information and express no opinion on it.

The financial section supporting schedules listed in the table-of-contents are presented for the purpose of additional analysis and are not a required part of the basic financial statements. These schedules are the responsibility of the System's management. Such schedules as of and for the year ended June 30, 2007 have been subjected to the auditing procedures applied in our audit of the basic financial statements and, in our opinion, are fairly stated in all material respects when considered in relation to the basic financial statements taken as a whole.

*Charles T. Mitchell Co.*

Frankfort, Kentucky  
December 5, 2007

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## **MANAGEMENT'S DISCUSSION AND ANALYSIS**

This discussion and analysis of Kentucky Teachers' Retirement System's financial performance provides an overview of the defined benefit and medical insurance plans' financial year ended June 30, 2007. Please read it in conjunction with the respective financial statements, which begin on page 7.

### **USING THIS FINANCIAL REPORT**

Because of the long-term nature of a defined benefit pension plan and medical insurance plan, financial statements alone cannot provide sufficient information to properly reflect the plan's ongoing plan perspective. The Statement of Plan Net Assets and Statement of Changes in Plan Net Assets (on pages 7-8) provide information about the activities of the defined benefit plan, medical insurance plan, and the tax-sheltered annuity plan as a whole. The Kentucky Teachers' Retirement System is the fiduciary of funds held in trust for its members.

The Schedules of Funding Progress (beginning on page 28) includes historical trend information about the actuarially funded status of each plan from a long-term, ongoing plan perspective and the progress made in accumulating sufficient assets to pay benefits and insurance premiums when due. The Schedules of Employer Contributions (beginning on page 28) presents historical trend information about the annual required contributions of employers and the contributions made by employers in relation to the requirement. These schedules provide information that contributes to understanding the changes over time in the funded status of the plans.

### **KENTUCKY TEACHERS' RETIREMENT SYSTEM AS A WHOLE**

In the fiscal year ended June 30, 2007, Kentucky Teachers' Retirement System's combined plan net assets increased by \$1,650.3 million - from \$13,983.5 million to \$15,633.8 million. The following summaries focus on plan net assets and changes in plan net assets of Kentucky Teachers' Retirement System's defined benefit plan, medical insurance plan, and the tax-sheltered annuity plan.

Summary of  
**Plan Net Assets**  
(In Millions)

Categories	Defined Benefit Plan			Medical Insurance Plan			TOTAL*		
	2007	2006	2005	2007	2006	2005	2007	2006	2005
Cash & Investments	\$16,273.6	\$14,632.5	\$14,144.4	\$137.0	\$132.1	\$153.3	\$16,410.6	\$14,764.6	\$14,297.7
Receivables	96.6	94.7	110.0	5.7	7.1	2.3	102.3	101.8	112.3
Capital Assets	3.1	3.2	3.3				3.1	3.2	3.3
Total Assets	\$16,373.3	\$14,730.4	\$14,257.7	\$142.7	\$139.2	\$155.6	\$16,516.0	\$14,869.6	\$14,413.3
Total Liabilities	(880.8)	(879.0)	(737.7)	(1.9)	(7.6)	(8.3)	(882.7)	(886.6)	(746.0)
Plan Net Assets	\$15,492.5	\$13,851.4	\$13,520.0	\$140.8	\$131.6	\$147.3	\$15,633.3	\$13,983.0	\$13,667.3

\*For the 403(b) Tax Shelter Plan cash and investments were approximately \$.5 million for the years ended 2007 and 2006 and 2005.

Summary of  
**Changes In Plan Net Assets**  
(In Millions)

Categories	Defined Benefit Plan			Medical Insurance Plan			TOTAL		
	2007	2006	2005	2007	2006	2005	2007	2006	2005
<b>ADDITIONS</b>									
Member Contributions	\$269.7	\$258.5	\$247.0	\$53.1	\$51.7	\$51.6	\$322.8	\$310.2	\$298.6
Employer Contributions	439.9	410.9	388.3	113.2	89.3	79.0	553.1	500.2	467.3
Investment Income (net)	2,060.5	717.3	946.1	6.7	6.8	6.5	2,067.2	724.1	952.6
Other Income				10.4	6.1		10.4	6.1	
TOTAL ADDITIONS	\$2,770.1	\$1,386.7	\$1,581.4	\$183.4	\$153.9	\$137.1	\$2,953.5	\$1,540.6	\$1,718.5
<b>DEDUCTIONS</b>									
Benefit Payments	\$1,106.8	\$1,035.6	\$963.4				\$1,106.8	\$1,035.6	\$963.4
Refunds	14.8	12.9	11.0				14.8	12.9	11.0
Administrative Expense	7.4	6.8	6.6	4.6	4.6	4.1	12.0	11.4	10.7
Insurance Expenses				169.6	165.0	142.3	169.6	165.0	142.3
TOTAL DEDUCTIONS	\$1,129.0	\$1,055.3	\$981.0	\$174.2	\$169.6	\$146.4	\$1,303.2	\$1,224.9	\$1,127.4
Increase (Decrease) in Plan Net Assets	\$1,641.1	\$331.4	\$600.4	\$9.2	(\$15.7)	(\$9.3)	\$1,650.3	\$315.7	\$591.1

Plan net assets of the defined benefit plan increased by 11.85% (\$15,492.5 million compared to \$13,851.4 million). The increase is primarily due to continued favorable market conditions which resulted in a net investment gain of \$2,060.5 million. These assets are restricted to providing monthly retirement allowances to members and their beneficiaries.

Plan net assets of the medical insurance plan increased by 7% (\$140.8 million compared to \$131.6 million) primarily due to state allocations to fund the plan. Plan assets are restricted to providing hospital and medical insurance benefits to members and their spouses.

## DEFINED BENEFIT PLAN ACTIVITIES

Member contributions increased \$11.2 million. Retirement contributions are calculated by applying a percentage factor to salary and are paid monthly by each member. Members may also pay contributions to repurchase previously refunded service credit or to purchase various types of elective service credit.

Employer contributions totaled \$439.9 million, a net increase of \$29 million over the 2006 fiscal year.

The System experienced strong returns in net investment, as the gain was greater than the previous year (\$2,060.5 million gain at June 30, 2007 as compared to a \$717.3 million gain at June 30, 2006). The increase in the fair value of investments is mainly due to continued favorable market conditions for the year ended June 30, 2007. This can be illustrated as follows:

<u>(In Millions)</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
Appreciation (depreciation) in fair value of investments – June 30, prior year	\$ 690.4	\$ 610.4	\$ 171.4
Appreciation (depreciation) in fair value of investments – June 30, end of year	<u>1,904.0</u>	<u>690.4</u>	<u>610.4</u>
Change in net appreciation (depreciation) in fair value of investments	1,213.6	80.0	439.0
Net income (net of investment expense)	443.1	434.8	433.8
Net gain on sale of investments	<u>403.8</u>	<u>202.5</u>	<u>73.3</u>
Investment Income (net) – June 30, end of year	\$2,060.5	\$ 717.3	\$ 946.1

Program deductions in 2007 increased \$73.7 million. The increase was caused principally by an increase of \$71.2 million in benefit payments. Members who were drawing benefits as of June 2006 received an increase of 2.3% (based on the amount of their retirement allowances) in July 2006. Also, there was an increase of 1,009 members and beneficiaries on the retired payroll as of June 30, 2007.

## MEDICAL INSURANCE PLAN ACTIVITIES

During the 2007 fiscal year, member contributions increased \$1.4 million and employer contributions increased by \$23.9 million over fiscal year 2006. The employer contributions increased primarily because \$73 million in stabilization funding was placed in the medical insurance fund from the pension fund as required by the 2006-2008 budget bill. The amount will be repaid over a ten-year period per KRS 161.553.

Program deductions increased \$4.6 million, which represents only a 2.7% increase. The downward trend is a result of two federal programs, Medicare Part D and Medicare Advantage, which have reduced costs for our Medicare eligible population. The monthly premium subsidy for retirees under age 65 increased 6% effective January 1, 2007. The monthly premium subsidy for retirees age 65 and over decreased 11%.

Net investment income decreased \$.1 million from \$6.8 million in 2006 to \$6.7 million in 2007. This is due to the recognition of interest income since all investments for the Medical Insurance Plan are short term in nature and the recognition of appreciation in fair value is not feasible. This can be illustrated as follows:

<u>(In Millions)</u>	<u>2007</u>	<u>2006</u>	<u>2005</u>
Appreciation in fair value of investments – June 30, prior year			
Appreciation in fair value of investments – June 30 end of year	\$ 0	\$ 0	\$ 0
Net appreciation in fair value of investments	<u>0</u>	<u>0</u>	<u>0</u>
Net income (net of investment expense)	0	0	0
Net gain on sale of investments	6.7	6.8	6.5
Investment Income (net) – June 30	<u>0</u>	<u>0</u>	<u>0</u>
	\$ 6.7	\$ 6.8	\$ 6.5

## **HISTORICAL TRENDS**

Accounting standards require that the statement of plan net assets state asset value at fair value and include only benefits and refunds due plan members and beneficiaries and accrued investment and administrative expenses as of the reporting date. Information regarding the actuarial funding status of the defined benefit plan and the medical insurance plan is provided in the Schedule of Funding Progress (beginning on page 28). The asset value, stated in the Schedule of Funding Progress, is determined by the System's independent actuary. The actuarial accrued liability is calculated using the projected unit credit cost method.

The 2007 fiscal year reveals a decline in funding position of the pension plan due to an increase in the actuarial liability.

The medical insurance plan is not as vulnerable to adverse market conditions since its assets are all short term in nature and less likely to experience huge fluctuations. Although, the plan continues to have a large unfunded actuarial liability, the current obligations are being met by current funding.

Annual required contributions of the employers are provided in the Schedule of Employer Contributions (on page 28). The 2007 employer shortfall of contributions created a net pension obligation of \$149,410,401.

**Kentucky Teachers' Retirement System**  
**Statement of Plan Net Assets**  
**As of June 30, 2007**

**Statement of Plan Net Assets**  
**As of June 30, 2007 and 2006**

	<b>Defined Benefit Plan</b>		<b>Medical Insurance Plan</b>		<b>403(b) Tax Shelter</b>		<b>TOTAL</b>	
	2007	2006	2007	2006	2007	2006	2007	2006
<b>ASSETS</b>								
Cash	\$5,387,902	\$9,629,298					\$5,387,902	\$9,629,298
Prepaid expenses	86,043	96,544	\$121,000				207,043	96,544
Receivables								
Contributions	29,275,912	29,953,514	\$2,240,981	\$1,118,926			31,516,893	31,072,440
State of Kentucky	956,905	5,673,887					956,905	5,673,887
Investment income	65,559,291	58,321,829			\$ 2,233	\$ 71	65,561,524	58,321,900
Installment account receivable	777,938	734,673					777,938	734,673
Medicare D receivables			3,487,197	5,999,560			3,487,197	5,999,560
Other receivables		59,932					0	59,932
<b>Total receivables</b>	<b>96,570,046</b>	<b>94,743,835</b>	<b>5,728,178</b>	<b>7,118,486</b>	<b>2,233</b>	<b>71</b>	<b>102,300,457</b>	<b>101,862,392</b>
Investments, at fair value (See Note 4)								
Short term investments	429,051,771	661,700,340	136,896,316	132,083,928	509,798	515,732	566,457,885	794,300,000
Bonds and mortgages	4,470,207,027	4,185,201,899					4,470,207,027	4,185,201,899
Common stock	10,114,620,014	8,531,993,656					10,114,620,014	8,531,993,656
Private equity	5,074,147						5,074,147	
Real estate	381,693,796	387,193,796					381,693,796	387,193,796
<b>Total investments</b>	<b>15,400,646,755</b>	<b>13,766,089,691</b>	<b>136,896,316</b>	<b>132,083,928</b>	<b>509,798</b>	<b>515,732</b>	<b>15,538,052,869</b>	<b>13,898,689,351</b>
Invested security lending collateral	867,562,185	856,631,934					867,562,185	856,631,934
Capital assets, at cost net of accumulated depreciation of \$1,871,494 (See Note 2)	3,085,129	3,180,032					3,085,129	3,180,032
<b>Total assets</b>	<b>16,373,338,060</b>	<b>14,730,371,334</b>	<b>142,745,494</b>	<b>139,202,414</b>	<b>512,031</b>	<b>515,803</b>	<b>16,516,595,585</b>	<b>14,870,089,551</b>
<b>LIABILITIES</b>								
Liabilities								
Accounts payable	2,819,398	1,713,031					2,819,398	1,713,031
Treasurer's unredeemed checks	2,217	13,823					2,217	13,823
Insurance claims payable			1,966,148	7,580,738			1,966,148	7,580,738
Compensated absences payable	636,201	601,135					636,201	601,135
Revenues collected in advance	9,799,500		7,112	7,391			9,806,612	7,391
Investment purchases payable		20,000,000					0	20,000,000
Obligations under securities lending	867,562,185	856,631,934					867,562,185	856,631,934
<b>Total liabilities</b>	<b>880,819,501</b>	<b>878,959,923</b>	<b>1,973,260</b>	<b>7,588,129</b>	<b>0</b>	<b>0</b>	<b>882,792,761</b>	<b>886,548,052</b>
Net assets held in trust for pension & post-employment healthcare benefits: (See Required Supplemental Schedule 1 for a schedule of funding progress.)	\$15,492,518,559	\$13,851,411,411	\$140,772,234	\$131,614,285	\$512,031	\$515,803	\$15,633,802,824	\$13,983,541,499
<b>The accompanying notes are an integral part of these financial statements.</b>								

**Kentucky Teachers' Retirement System**  
**Statement of Changes in Plan Net Assets**  
**As of June 30, 2007**

**Statement of Changes in Plan Net Assets**  
**For the Years Ended June 30, 2007 and 2006**

	<b>Defined Benefit Plan</b>		<b>Medical Insurance Plan</b>		<b>403(b) Tax Shelter</b>		<b>TOTAL</b>	
	2007	2006	2007	2006	2007	2006	2007	2006
<b>ADDITIONS</b>								
Contributions								
Employer	\$ 439,912,606	\$ 410,920,969	\$ 113,233,784	\$ 89,319,498			\$ 553,146,390	\$ 500,240,467
Member	269,687,864	258,464,856	53,099,678	51,697,167			322,787,542	310,162,023
<b>Total contributions</b>	709,600,470	669,385,825	166,333,462	141,016,665	0	0	875,933,932	810,402,490
Other Contributions								
Recovery income			24,977	118,419			24,977	118,419
Medicare D receipts			10,312,361	5,999,560			10,312,361	5,999,560
<b>Total other contributions</b>			10,337,338	6,117,979			10,337,338	6,117,979
Investment Income								
Net Appreciation/(Depreciation) in FV of Investments	1,617,337,060	282,572,648					1,617,337,060	282,572,648
Interest	254,925,905	255,566,732	6,722,080	6,804,286	\$ 28,919	\$ 21,454	261,676,904	262,392,472
Dividends	165,183,866	153,566,960					165,183,866	153,566,960
Rental Income, Net	30,344,247	30,949,900					30,344,247	30,949,900
Securities Lending, Gross Earnings	52,672,196	28,464,668					52,672,196	28,464,668
<b>Gross Investment Income</b>	2,120,463,274	751,120,908	6,722,080	6,804,286	28,919	21,454	2,127,214,273	757,946,648
Less Investment Expense	(8,667,669)	(6,156,584)					(8,667,669)	(6,156,584)
Less Securities Lending Expense	(51,330,375)	(27,656,322)					(51,330,375)	(27,656,322)
Net Investment Income	2,060,465,230	717,308,002	6,722,080	6,804,286	28,919	21,454	2,067,216,229	724,133,742
<b>Total additions</b>	2,770,065,700	1,386,693,827	183,392,880	153,938,930	28,919	21,454	2,953,487,499	1,540,654,211
<b>DEDUCTIONS</b>								
Benefits	1,106,783,879	1,035,606,281			32,691	37,925	1,106,816,570	1,035,644,206
Refunds of contributions	14,822,827	12,834,222	5,834	5,143			14,828,661	12,839,365
Insurance expenses			169,577,773	165,006,322			169,577,773	165,006,322
Administrative expense	7,351,846	6,839,859					7,351,846	6,839,859
Medical administrative expense			4,651,324	4,624,074			4,651,324	4,624,074
<b>Total deductions</b>	1,128,958,552	1,055,280,362	174,234,931	169,635,539	32,691	37,925	1,303,226,174	1,224,953,826
<b>Net increase (decrease)</b>	1,641,107,148	331,413,465	9,157,949	(15,696,609)	(3,772)	(16,471)	1,650,261,325	315,700,385
<b>Net assets held in trust for pension &amp; post employment healthcare benefits</b>								
<b>Beginning of year</b>	13,851,411,411	13,519,997,946	131,614,285	147,310,894	515,803	532,274	13,983,541,499	13,667,841,114
<b>Ending of year</b>	<u>\$15,492,518,559</u>	<u>\$13,851,411,411</u>	<u>\$140,772,234</u>	<u>\$131,614,285</u>	<u>\$512,031</u>	<u>\$515,803</u>	<u>\$15,633,802,824</u>	<u>\$13,983,541,499</u>
The accompanying notes are an integral part of these financial statements.								



## Notes to Financial Statements Years Ended June 30, 2007 and 2006

### Note 1: Description of Plan

#### A. REPORTING ENTITY

The Teachers' Retirement System of the State of Kentucky (KTRS) was created by the 1938 General Assembly and is governed by Chapter 161 Section 220 through Chapter 161 Section 990 of the Kentucky Revised Statutes (KRS). KTRS is a blended component unit of the Commonwealth of Kentucky and therefore is included in the Commonwealth's financial statements. KTRS is a cost-sharing multiple-employer defined benefit plan established to provide pension benefit plan coverage for local school districts and other public educational agencies in the state.

#### B. PARTICIPANTS

As of June 30, 2007 a total of 198 employers participated in the plan. Employers are comprised of 175 local school districts, 17 Department of Education Agencies and other educational organizations, 5 universities and also the Kentucky Community and Technical College System.

According to KRS 161.220 " . . . any regular or special teacher, or professional occupying a position requiring certification or graduation from a four (4) year college or university . . . " is eligible to participate in the System. The following illustrates the classifications of members:

Active contributing members:	<u>2007</u>	<u>2006</u>
Vested	42,300	41,656
Non-vested	32,844	32,084
Inactive members, vested	4,498	4,275
Retirees and beneficiaries currently receiving benefits	<u>39,506</u>	<u>38,497</u>
Total members, retirees, and beneficiaries	<b>119,148</b>	<b>116,512</b>

#### C. BENEFIT PROVISIONS

Members become vested when they complete five (5) years of credited service. To qualify for monthly retirement benefits, payable for life, members must either:

- 1.) Attain age fifty-five (55) and complete five (5) years of Kentucky service, or
- 2.) Complete 27 years of Kentucky service.

Note 1: Description of Plan continued . . .

Participants that retire before age 60 with less than 27 years of service receive reduced retirement benefits. Non-university members receive monthly payments equal to two (2) percent (service prior to July 1, 1983) and two and one-half (2.5) percent (service after July 1, 1983) of their final average salaries for each year of credited service. University employees receive monthly benefits equal to two (2) percent of their final average salary for each year of credited service. The final average salary is the member's five (5) highest annual salaries except members at least 55 with 27 or more years of service may use their (3) three highest annual salaries. New members (including second retirement accounts started) after July 1, 2002 will receive monthly benefits equal to 2% of their final average salary for each year of service if, upon retirement, their total service is less than ten years. New members after July 1, 2002 who retire with ten or more years of total service will receive monthly benefits equal to 2.5% of their final average salary for each year of service, including the first ten years. In addition, members who retire July 1, 2004 and later with more than 30 years of service will have their multiplier increased for all years over 30 from 2.5% to 3.0% to be used in their benefit calculation

The system also provides disability benefits for vested members at the rate of sixty (60) percent of the final average salary. A life insurance benefit, payable upon the death of a member, is \$2,000 for active contributing members and \$5,000 for retired or disabled members.

Cost of living increases are one and one-half (1.5) percent annually. Additional ad hoc increases, and any other benefit amendments must be authorized by the General Assembly.

<b>Note 2: Summary of Significant Accounting Policies</b>
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**A. BASIS OF ACCOUNTING**

The financial statements are prepared on the accrual basis of accounting. Member contributions and employer matching are recognized in the fiscal year due. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

**B. CASH**

KTRS has three cash accounts. At June 30, 2007, the pension cash account totaled \$2,385,015 the administrative expense fund cash account was \$2,247,837 and the life insurance cash account totaled \$755,050 therefore, the carrying value of cash was \$5,387,902 and the corresponding bank balance was \$8,383,923. The variance is primarily due to outstanding checks and items not processed by the bank on June 30, 2007.

**C. CAPITAL ASSETS**

Fixed assets are recorded at historical cost less straight-line accumulated depreciation. The classes of fixed assets are furniture and equipment, the KTRS office buildings and land. Furniture and equipment are depreciated over an average useful life of five to seven years. The office buildings are depreciated over forty years.

Note 2: Summary of Significant Accounting Policies continued . . .

**D. INVESTMENTS**

Plan investments are reported at fair value. Fair value is the amount that a plan can reasonably expect to receive for an investment in a current sale between a willing buyer and a willing seller. Short-term securities are carried at cost, which approximates fair value. Fixed income and common and preferred stocks are generally valued based on published market prices and quotations from national security exchanges and securities pricing services. Real estate is primarily valued based on appraisals performed by independent appraisers.

Purchase and sales of debt securities, equity securities, and short-term investments are recorded on the trade date. Real estate equity transactions are recorded on the settlement date. Upon sale of investments, the difference between sales proceeds and cost is reflected in the statement of changes in plan net assets.

Investment expenses consist of investment manager and consultant fees along with fees for custodial services.

**E. COMPENSATED ABSENCES**

Expenses for accumulated vacation days and compensatory time earned by the System's employees are recorded when earned. Upon termination or retirement, employees of the system are paid for accumulated vacation time limited to 450 hours and accumulated compensatory time limited to 200 hours. As of June 30, 2007 and 2006 accrued compensated absences were \$636,201 and \$601,135.

**F. RISK MANAGEMENT**

Destruction of assets, theft, employee injuries and court challenges to administrative policy are among the various risks to which the system is exposed. In order to cover such risks the system carries appropriate insurance policies such as fire and tornado, employee bonds, fiduciary liability, worker's compensation and equipment insurance.

**G. OTHER RECEIVABLES**

KTRS now allows qualified purchases of service credit to be made by installment payments not to exceed a five-year period. Revenue is recognized in the initial year of the installment contract agreement. The June 30, 2007 and 2006 installment contract receivables were \$777,938 and \$734,673.

**H. USE OF ESTIMATES**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**I. INCOME TAXES**

The defined benefit plan is organized as a tax-exempt retirement plan under the Internal Revenue Code. The tax sheltered annuity plan is no longer continued and will be fully terminated when all lifetime annuities have expired. The system's management believes that it has operated the plans within the constraints imposed by federal tax law.

Note 2: Summary of Significant Accounting Policies continued . . .

## **J. ACCOUNTING CHANGES**

As required, the System has implemented GASB # 43 Financial Reporting for Post-employment Benefit Plans Other Than Pension Plans. Also, the System has early implemented GASB #50 Pension Disclosures.

<b>Note 3: Contributions and Reserves</b>
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## **A. CONTRIBUTIONS**

Contribution rates are established by Kentucky Revised Statutes. Members are required to contribute 9.855% of their salaries to the System. University members are required to contribute 8.375% of their salaries. KRS 161.580 allows each university to reduce the contribution of its members by 2.215%; therefore, university members contribute 6.16% of their salary to KTRS.

The Commonwealth of Kentucky is required to contribute 13.105% of salaries for its non-university members and 13.84% of salaries for university members.

The member and employer contributions consist of pension contributions and post-retirement contributions to the medical insurance fund. The post-retirement contribution of .75% from employee and employer contribution rates help finance KTRS' retiree medical insurance plan.

If an employee leaves covered employment before accumulating five (5) years of credited service, accumulated employee contributions plus interest are refunded to the employee upon the member's request.

## **B. RESERVES**

### **Member Reserve**

This fund was established by KRS 161.420(2) as the Teacher Savings Fund and consists of contributions paid by university and non-university members. The fund also includes interest authorized by the Board of Trustees from Unallocated Reserves. The accumulated contributions of members that are returned upon withdrawal or paid to the estate or designated beneficiary in the event of death are paid from this fund. Upon retirement, the member's contributions and the matching state contributions are transferred from this fund to Benefit Reserves, the fund from which retirement benefits are paid.

### **Employer Reserve**

This fund was established by KRS 161.420(3) as the State Accumulation Fund and receives state appropriations to the Retirement System. The state matches an amount equal to members' contributions. State appropriations during the year are based on estimates of

members' salaries. At year-end when actual salaries are known, the required state matching is also realized by producing either a receivable from or a payable to the State of Kentucky. While fiscal years 2007 and 2006 resulted in over-appropriations from the state, a receivable is still due from the state because prior years under-appropriations have not been paid to KTRS.

### **Benefit Reserve**

This fund was established by KRS 161.420(4) as the Allowance Reserve Fund, the source for retirement, disability, and survivor benefits paid to members of the System. These benefits are paid from the retired members' contributions until they are exhausted, at which time state matching contributions are used to pay the benefits. After an individual member's contributions and the state matching contributions have been exhausted, retirement benefits are paid from monies transferred from Unallocated Reserves.

### **Unallocated Reserve**

This fund was established by KRS 161.420(6) as the Guarantee Fund to collect income from investments, state matching contributions of members withdrawn from the System, and state matching contributions for cost of living adjustments (COLAs). In addition, it receives money for which disposition is not otherwise provided. This fund provides interest to the other funds, benefits in excess of both members' and state matching contributions, monies for administrative expenses of the System, and deficiencies not covered by the other funds.

### **Administrative Expense Reserve**

This fund was established by KRS 161.420(1) as the Expense Fund. Investment income transferred to this fund from Unallocated Reserves is used to pay the administrative expenses of the System.

### **Life Insurance Reserve**

This fund was established pursuant to the provisions of KRS 161.655 to provide a life insurance benefit to retired and active members of the Kentucky Teachers' Retirement System. This benefit is financed by KTRS employer contributions that are actuarially determined.

## **Note 4: Funded Status and Funding Progress**

### **A. Description of Funding Progress**

The funded status of the Defined Benefit Plan as of the most recent actuarial valuation date is as follows (dollar amounts in 1,000's):

Valuation Year June 30	Actuarial Value of Assets	Actuarial Accrued Liabilities	Unfunded Actuarial Accrued Liabilities (uaal)	Funded Ratio	Covered Payroll	UAAL as a % of Covered Payroll
	A	B	B-A	(A/B)	C	[(B-A)/C]
2007	\$15,284,955	\$21,254,974	\$5,970,019	71.9%	\$2,975,289	200.7%

Note 4: Funded Status and Funding Progresscontinued . . .

The schedule of funding progress, presented as required supplementary information following the notes to the financial statements, presents multiyear funding trend information as obtained from the System's independent actuary's annual valuation report.

Expressing the actuarial value of assets as a percentage of the actuarial accrued liabilities provides an indication whether the system is becoming financially stronger or weaker. Generally, the greater the percentage the stronger the retirement system. Trends in unfunded actuarial accrued liabilities and annual covered payroll are both affected by inflation. Expressing the unfunded actuarial accrued liabilities as a percentage of annual covered payroll aids analysis of progress made in accumulating sufficient assets to pay benefits when due. Generally, the smaller this percentage the stronger the retirement system.

The accompanying schedule of employer contributions, presented as required supplementary information following the notes to the financial statements, presents trend information about the amounts contributed to the plan by employers in comparison to the Annual Required Contribution (ARC). The ARC is actuarially determined in accordance with the parameters of GASB Statement 50. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover normal cost for each year and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed thirty years.

## **B. Methodologies**

The promised benefits of the System are included in the actuarially calculated contribution rates, which are developed using the projected unit credit actuarial cost method. Gains and losses are reflected in the unfunded accrued liability that is being amortized by regular annual contributions as a level percentage of payroll within a 30-year period using an open amortization approach. The five (5) year smoothed market approach is used for asset valuation.

Note 4: Funded Status and Funding Progresscontinued . . .

<b>Actuarial Value Assets</b>	
(1) Actuarial Value of Assets on June 30, 2006	\$ 14,857,641,238
(2) Market Value End of Year June 30, 2007	\$ 15,421,092,446
(3) Market Value Beginning of Year June 30, 2006	\$ 13,783,830,173
(4) Cash Flow	
a. Contributions	\$ 704,578,332
b. Benefit Payments	<u>1,117,361,706</u>
c. Net	\$ (412,783,374)
(5) Investment Income	
a. Market total: (2) - (3) - (4)c	\$ 2,050,045,647
b. Assumed Rate	7.5%
c. Amount for Immediate Recognition: [(1) x (5)b] + [(4)c * (5)b * 0.5]	\$ 1,098,843,716
d. Amount for Phased-In Recognition: (5)a - (5)c	\$ 951,201,931
(6) Phased-In Recognition of Investment Income	
a. Current Year: 0.20*(5)d	\$ 190,240,386
b. First Prior Year	(75,996,339)
c. Second Prior Year	(23,843,540)
d. Third Prior Year	(349,147,545)
e. Fourth Prior Year	<u>0</u>
f. Total Recognized Investment Gain	\$ (258,747,038)
(7) Actuarial Value End of Year (1) + (4)c + (5)c + (6)f	\$ 15,284,954,542
(8) Difference Between Market & Actuarial Values (2) - (7)	\$ 136,137,904

### C. Assumptions

Significant actuarial assumptions employed by the actuary for the funding purposes as of June 30, 2007, the most recent updated actuarial information include:

- \* Assumed inflation rate 4%
- \* Assumed investment rate 7.5%
- \* Assumed projected salary increases 4.0% - 8.20
- \* Assumed post retirement benefit increase 1.5%

<p><b>Note 5: Deposits With Financial Institutions and Investments (Including Repurchase Agreements)</b></p>
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**A. LEGAL PROVISIONS FOR INVESTMENTS**

The following disclosures are meant to help the users of KTRS' financial statements assess the risks KTRS takes in investing public funds. The Board of Trustees and the Investment Committee are guided by asset allocation parameters that the Board approves through its powers as defined in KRS 161.430. The parameters as outlined in Title 102, Chapter 1.175, Section 2 of the Kentucky Administrative Regulations are as follows:

- ◆ There shall be no limit on the amount of investments owned by the System that are guaranteed by the U.S. Government.
- ◆ Not more than thirty-five percent (35%) of the assets of the System at book value shall be invested in corporate debt obligations.
- ◆ Not more than sixty percent (60%) of the assets of the System at book value shall be invested in common stocks or preferred stocks. Not more than twenty-five percent (25%) of the assets of the System at book value shall be invested in a stock portfolio designed to replicate a general, United States stock index.
- ◆ Not more than ten percent (10%) of the assets of the System at book value shall be invested in real estate. This would include real estate equity, real estate lease agreements, mortgages on real estate that are not guaranteed by the U.S. Government, and shares in real estate investment trusts.
- ◆ Not more than one percent (1%) of the assets of the System at book value shall be invested in venture capital investments, providing at least seventy-five percent (75%) of such investments must be in-state.
- ◆ Not more than ten percent (10%) of the assets of the System at book value shall be invested in any additional category or categories of investments. The Board of Trustees shall approve by resolution such additional category or categories of investments. Within this parameter, to further diversify the portfolio, the Board approved provisions that permit the limited ownership of foreign equities, timberland and private equity.

**B. CASH AND CASH EQUIVALENTS**

For cash deposits and cash equivalents, custodial credit risk is the risk that, in the event of a bank failure, the retirement system's deposits may not be returned to the system. The bank's total balance at June 30, 2007 was \$8,383,923 of which \$3,751,150 primarily represents deposited amounts due the System for which actual funds are in transit to and waiting to be received by the custodial bank; therefore, these funds were unavailable for investment. An additional amount of \$2,247,837 represents funds held in the bank but their



Note 5: Deposits With Financial Institutions and Investments (Including Repurchase Agreements) continued . . .

investment is controlled by the Commonwealth of Kentucky. The remaining bank balance amount of \$2,384,936 was the amount invested in cash equivalents. Cash equivalents are created through the daily sweeps of available excess cash by the System's custodial bank into bank sponsored short-term investment funds. These funds are custodial bank sponsored commingled funds which are invested in short-term securities backed by the U.S. Government and its agencies. The actual cash deposits held in bank accounts are insured up to \$100,000 as covered by federal depository insurance and uncollateralized until being invested in cash equivalents.

Deposits are exposed to custodial credit risk if they are not covered by depository insurance and the deposits are:

- a. uncollateralized,
- b. collateralized with securities held by the pledging financial institution, or
- c. collateralized with securities held by the pledging financial institution's trust department or agent but not in the depositor-government's name.

As of June 30, 2007, the System's cash equivalents in the amount of \$2,384,936 were not exposed to custodial credit risk since this amount was invested by the custodial bank and collateralized at 102% with the collateral pledged to the Treasurer of the Commonwealth of Kentucky.

### **C. INVESTMENTS**

All of the System's assets are invested in short-term and long-term debt (bonds and mortgages) securities, equity (stock) securities, and real estate. These assets are reported at fair market value.

Investments are governed by the Board of Trustees' policy while the Board of Trustees and the Investment Committee shall execute their fiduciary responsibilities in accordance with the "prudent person rule", as identified in KRS 161.430 (2)(b). The prudent person rule establishes a standard for all fiduciaries, to act as a prudent person would be expected to act, with the "care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with these matters would use in the conduct of an enterprise of a like character and with like aims".

The following chart represents the fair market values of the investments of the Kentucky Teachers' Retirement System for June 30, 2007.

Note 5: Deposits With Financial Institutions and Investments (Including Repurchase Agreements) continued . . .

<b>Schedule of Investments</b>		
	<b>June 30, 2007</b>	<b>June 30, 2006</b>
<b>Short Term Investments</b>		
Repurchase Agreements	\$ 566,457,885	\$ 794,300,000
Total Short Term Investments	\$ 566,457,885	\$ 794,300,000
<b>Bonds and Mortgages</b>		
U.S. Government Obligations		
Treasury Notes & Bonds	\$ 1,051,762,064	\$ 1,032,439,779
Agencies	1,286,289,341	1,039,092,693
GNMA (Single Family)	26,143,119	18,781,578
Other Miscellaneous	<u>162,647,870</u>	<u>168,353,243</u>
Total U.S. Government Obligations	\$ 2,526,842,394	\$ 2,258,667,293
Corporate Bonds		
Industrial	\$ 474,857,147	\$ 542,410,465
Finance	1,034,761,668	1,023,985,966
Utility Bonds (Except Telephone)	130,574,788	119,160,317
Telephone Bonds	<u>40,739,639</u>	<u>46,512,518</u>
Total Corporate Bonds	\$ 1,680,933,242	\$ 1,732,069,266
Other Fixed Income Investments		
FHA and VA Single Family Mortgages	\$ 0	\$ 1,904
Project Mortgages (FHA & GNMA)	10,094,638	13,687,213
State and Local Government Issues	<u>252,336,753</u>	<u>180,776,223</u>
Total Other Investments	\$ 262,431,391	\$ 194,465,340
Total Bonds and Mortgages	\$ 4,470,207,027	\$ 4,185,201,899
<b>Stocks</b>	\$ 10,114,620,014	\$ 8,531,993,656
Private Equity	5,074,147	0
Real Estate	<u>381,693,796</u>	<u>387,193,796</u>
<b>TOTAL INVESTMENTS</b>	<b>\$ 15,538,052,869</b>	<b>\$ 13,898,689,351</b>
<i>This Schedule does not include \$867,562,185 securities lending collateral.</i>		

### **Custodial Credit Risk**

Custodial Credit Risk for an investment is the risk that, in the event of the failure of counterparty, the pension trust fund will not be able to recover the value of its investment or collateral securities that are in the possession of an outside party. Investment securities are exposed to custodial credit risk if the securities are uninsured, are not registered in the name of the retirement system, and are held by either:

- a. the counterparty or
- b. the counterparty's trust department or agent, but not in the System's name.

Note 5: Deposits With Financial Institutions and Investments (Including Repurchase Agreements) continued . . .

The cash reserve of the System is maintained in high quality short term investments. Commercial paper, U.S. Treasury and agency obligations, certificates of deposit, banker's acceptances, and repurchase agreements are all permissible investments. The System utilized investment instruments it regards as the most secure and having the best returns and does not use short term investments that finance foreign businesses unless they are issued and guaranteed by the United States Government.

Individual repurchase agreements are ordered by KTRS under the terms of Master Repurchase Agreements with various brokers under terms dictated by KTRS. The repurchase agreements and their supporting collateral are held by the custodial agent's correspondent bank in an account identified by the custodian's name and KTRS' nominee name. This account is unique to KTRS. The Master Repurchase Agreements require that the supporting collateral have a market value of at least 102% of the value of the repurchase agreements.

In addition to the System's \$15.5 billion in investments at June 30, 2007, cash collateral reinvestment securities acquired through securities lending by the System's custodian, whom is also the lending agent/counterparty amounted to \$867,562,185. This is consistent with the System's securities lending agreement with the custodian. (Please refer to a following section entitled Securities Lending.)

### **Interest Rate Risk**

Interest rate risk on investments is the possibility that changes in interest rates will reduce the fair value of the retirement System's investments. In general, the longer the period until an investment matures, the greater the negative impact that changes in interest rates can have on fair value.

As of June 30, 2007 KTRS had the following investments and weighted average maturities:

<b><u>Investment Type</u></b>	<b><u>Fair Value</u></b>	<b><u>Average Maturity (years)</u></b>
U.S. Treasuries	\$ 1,072,697,874	10.3
Agencies	1,286,289,341	9.6
Corporate Bonds	1,680,933,243	9.9
Mortgage Pass-Throughs	36,237,757	23.3
State & Local Govt Issues	252,336,753	15.4
Collateralized Mortgage Obligations	<u>141,712,059</u>	<u>21.2</u>
<b>Totals</b>	<b>4,470,207,027</b>	<b>10.7</b>

Note 5: Deposits With Financial Institutions and Investments (Including Repurchase Agreements) continued . . .

In addition to the above securities, Repurchase Agreements (short-term investments) had a total fair value of \$566,457,885 with an average maturity of 2 days and other short-term notes/bonds had an average maturity of 26 days. Average maturity is used as a measure of a security's exposure to interest rate risk due to fluctuations in market interest rates. Mortgage pass-throughs and collateralized mortgage obligations are typically amortizing investments with an average life and interest rate risk, significantly less than suggested by the legal maturity. Mortgage-backed securities, which are generally pre-payable, and other callable bonds are subject to adverse changes in average life in response to market interest rate changes. The schedule above reflects only the legal maturity of all such bonds.

The System does not have a formal investment policy that limits investment maturities as a means of managing its exposure to potential fair value losses arising from future changes in interest rates. Market or interest rate risk is the greatest risk faced by an investor in the debt securities market. The price of a debt security typically moves in the opposite direction of the change in interest rates. Mortgages held by the System are fixed interest rate mortgages.

Collateralized mortgage obligations (CMOs) are bonds that are collateralized by whole loan mortgages, mortgage pass-through securities or stripped mortgage-backed securities. Income is derived from payments and prepayments of principal and interest generated from collateral mortgages. Cash flows are distributed to different investment classes in accordance with a CMO's established payment order. The System held \$141.7 million in CMOs as of June 30, 2007.

Asset-backed securities (ABS) are bonds or notes backed by loan paper or accounts receivable originated by banks, credit card companies, or other credit providers. The originator of the loan or accounts receivable paper sells it to a specially created trust, which repackages it as securities. ABSs have been structured as pass-throughs and as structures with multiple bond classes. The ABSs held by the system and reported in the corporate bond category above are moderately sensitive to changes in interest rates.

### **Credit Risk**

Credit risk is the risk that an issuer or counterparty to an investment will not fulfill its obligations. The following schedule lists KTRS's investments according to credit ratings as of June 30, 2007:

<b><u>RATING</u></b>	<b><u>FAIR VALUE</u></b>
Repurchase Agreements	\$ 264,900,000
Treasury	1,072,697,874
Agency	1,765,797,042
AAA	659,775,773
AA	478,234,066
A	632,478,238
BAA	152,286,779
BA	2,700,000
B	7,795,140
<u>Total</u>	<u>\$ 5,036,664,912</u>

Note 5: Deposits With Financial Institutions and Investments (Including Repurchase Agreements) continued . . .

Total market value of the short-term and the fixed income portfolio was \$5,036,664,912 on June 30, 2007. The rating system used in the chart is the nationally recognized Moody's Investors Service rating system. The credit risk associated with repurchase agreements and Agency investments is very minimal as the general rating of these securities is higher than AAA. Notation is made that the ratings of securities is subject to change due to circumstances and thereby may have a lower rating than when first purchased.

The System's policy on credit rating as stated in 102 KAR 1:175 is that:

"A fixed income investment shall be rated at the time of purchase within the four (4) highest credit classifications identified by one (1) of the major rating services. A private placement debt investment shall be subject to the same credit qualifications as each fixed income investment. Notwithstanding the foregoing, the fixed income investment portfolio as a whole shall maintain an average rating equal to at least the second highest credit classification."

#### **Concentration of Credit Risk**

Concentration of credit risk is the risk of loss attributed to the magnitude of a government's investment in a single issuer. Losses from credit risk are heightened if a significant portion of resources are invested with a single issuer. Per Administrative Regulation 102 KAR 1:175, the System is subject to the following policies regarding single issuers of fixed income and equity securities:

"Unless the issuer is the United States Government or one (1) of its agencies, the amount invested in the securities of a single issuer shall not equal more than five (5) percent of the assets of the system at book value.

"The System's position in a single stock shall not exceed two (2) percent of the System's assets at book value. The system's position in a single stock shall not exceed five (5) percent of the outstanding stock for that company unless the investment is part of a venture capital program approved by the Board of Trustees or the Investment Committee."

KTRS has not invested greater than five percent (5%) of the System's assets at book value in any single issuer and is in compliance with the System's policies as stated here.

#### **Foreign Currency Risk**

As of June 30, 2007, KTRS exposure to foreign currency risk consisted of \$522,413,573 of foreign equity investments through a commingled fund managed by UBS Global Asset Management. This amount represented the portion of market value of the total fund attributed to cash investments contributed to the Fund by KTRS.

In addition to the commingled fund allocation, stocks held associated with foreign interests were American Depositary Receipt (ADR) investments which are securities that are issued by a U.S. bank in place of the foreign stock shares held in trust by that bank, thereby facilitating the trading of foreign shares in U.S. markets. ADRs are denominated in U.S. currency.

Note 5: Deposits With Financial Institutions and Investments (Including Repurchase Agreements) continued . . .

The System's policy regarding foreign equities is that "Not more than 10% of the assets of the System at book value shall be invested in any additional category or categories of investments..... Within this parameter, to further diversify the portfolio, the Board approved provisions that permit the limited ownership of foreign equities, timberland and private equity."

#### **D. SECURITIES LENDING**

Section 161.430 of the Kentucky Revised Statutes empowers the Board of Trustees with complete fiduciary responsibility for the funds of the System. The System operates a securities lending program in which it temporarily lends securities to qualified agents in exchange for a net fee and high quality collateral. U.S. Government and agency securities and selected domestic stocks and bonds are the types of securities that are lent. The System's sub-custodian, The Bank of New York, acts as lending agent in exchanging securities for collateral. The collateral has a value of not less than 102% of the market value of the lent securities plus any accrued, unpaid distributions. The collateral may consist of cash, marketable U.S. Government securities, and select marketable U.S. Government agency securities approved by the System.

Securities lending transactions are accounted for in accordance with GASB Statement No. 28 Accounting and Financial Reporting for Securities Lending Transactions, which established standards of accounting and financial reporting for securities lending transactions. The following section details the net income earned from securities lending for the fiscal year ended June 30, 2007:

<u>ITEM</u>	<u>EARNINGS</u>
Gross Earnings (Interest and fees)	\$ 52,672,196
Less: Gross Borrower Rebates	50,753,953
Bank Fees	565,230
Other	<u>11,192</u>
Net Earnings	<u><u>\$ 1,341,821</u></u>

Cash collateral is invested in short-term obligations fully guaranteed by the United States Government or select Government agencies and Government Repurchase Agreements with qualified agents. The System cannot pledge or sell collateral securities received unless the borrower defaults. The lending agent (Bank of New York) also indemnifies the System from any financial loss associated with a borrower's default and collateral inadequacy. As of June 30, 2007 the loan average days to maturity was one day and the weighted average maturity of cash collateral investments was two days.

Note 5: Deposits With Financial Institutions and Investments (Including Repurchase Agreements) continued . . .

At fiscal year end, the System has no credit risk exposure to borrowers, since the amounts the System owes the borrowers exceeds the amounts the borrowers owe the System and there were no losses resulting during the period.

Security lending programs can entail interest rate risk and credit risk. The System minimizes interest rate risk by limiting the term of cash collateral investments to several days. The credit risk is controlled by investing cash collateral in securities with qualities similar to the credit worthiness of lent securities.

The following table presents the fair values of the underlying securities, and the value of the collateral pledged at June 30, 2007:

Type of Security Lent	Fair Value	Cash Collateral Received Non-Cash Collateral Value*
U.S. Government and Agencies	\$ 733,349,697	\$ 744,180,424
U.S. Equities	119,825,017	123,381,761
<b>TOTAL</b>	<b>\$ 853,174,714</b>	<b>\$ 867,562,185</b>

*\*Represents value of cash collateral only. Loan or margin collateral requirements met via the use of non-cash collateral (e.g. Government securities or Letters of Credit) are excluded from these values.*

### **Note 6: Pension Plan for Employees of the System**

Full-time employees of Kentucky Teachers' Retirement System (KTRS) participate in either KTRS or Kentucky Employees Retirement System. Both plans are multiple-employer cost sharing defined benefit pension plans. All KTRS employees in positions requiring a four-year degree are covered under KTRS. The contribution rates and required employer matching are the same as state agency employers in the system. These rates, the plan description and funding policy are fully disclosed in the notes to the financial statements.

The System's annual required contributions for KTRS employee members for the fiscal years 2007, 2006 and 2005 were \$388,973, \$368,662, and \$355,095 respectively. KTRS contributed 100% of the required contribution each year.

All other KTRS employees are covered under the Kentucky Employee Retirement System (KERS) in the Non-Hazardous Employees Pension Plan. The plan provides for retirement, disability, and death benefits to plan members. Retirement benefits may be extended to

Note 6: Pension Plan for Employees of the System continued . . .

beneficiaries of plan members under certain circumstances. Per KRS 61.565(3), contribution rates shall be determined by the Board on the basis of an annual actuarial valuation. Rates may be amended by the Board as needed. The System's administrative budget and employer contribution rates are subject to the approval of the Kentucky General Assembly. Employee contribution rates are set by the statute and may be changed only by the Kentucky General Assembly.

Members of KERS were required to contribute 5% of their annual creditable compensation for the fiscal years 2007, 2006, and 2005. As the employer, KTRS is required to contribute the annual actuarially determined rate of the creditable compensation (or the rate approved by legislators). The approved rate for the fiscal years 2007, 2006 and 2005 were 7.75%, 5.89% and 5.89%; and the System's annual required contributions to KERS were \$114,711, \$103,137 and \$268,975 respectively. KTRS contributed 100% of the required contributions for each year.

KERS issues a publicly available financial report that may be obtained by writing Kentucky Retirement System, 1260 Louisville Road, Frankfort, Kentucky 40601-6124.

<b>Note 7: 403(b) Tax-Sheltered Annuity Plan</b>
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**A. PLAN DESCRIPTION**

KTRS has, in prior years, administered a salary deferral program as permitted by section 403(b) of the Internal Revenue Code. Under this program members were able to voluntarily defer a portion of their compensation within the limits established by the applicable laws and regulations. However, the System's Board of Trustees determined that the cost of providing the necessary services to assure the System of continuing compliance with these laws and regulations was not economically feasible due to the limited participation in the program by the System's members. The Board decided, therefore, to discontinue offering the program as of April 30, 1997. Members who were not receiving annuities from their account as of April 30, 1997, were able to transfer their respective accounts directly into other tax-sheltered plans on a tax-free basis. As of June 30, 2007, the twenty-nine members who are receiving annuities will continue to receive distributions according to the terms of their respective elections.

**B. SUMMARY OF SIGNIFICANT POLICIES**

**Basis of Accounting**

The Tax-sheltered Annuity Plan financial statements are prepared using an accrual basis of accounting. Contributions are no longer being accepted into the plan, therefore, there are no receivables to be recognized.



Note 6: 403(b) Tax-Sheltered Annuity Plan continued . . .

**Method Used to Value Investments**

The short-term investments are reported at cost, which approximates fair value.

<p><b>Note 8: Medical Insurance Plan &amp; Post-Employment Benefits</b></p>
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**A. PLAN DESCRIPTION**

In addition to pension benefits described in Note 1, Kentucky Revised Statute 161.675 requires KTRS to provide post-retirement healthcare benefits to eligible members and dependents. The KTRS Medical Insurance benefit is a cost-sharing multiple employer defined benefit plan. Changes made to the medical plan may be made by the KTRS Board of Trustees, the Kentucky Department of Employee Insurance and the General Assembly.

To be eligible for medical benefits, the member must have retired either for service or disability. The KTRS Medical Insurance Fund offers coverage to members under the age of 65 through the Kentucky Employees Health Plan administered by the Kentucky Department of Employee Insurance. KTRS retired members are given a supplement to be used for payment of their health insurance premium. The amount of the member's supplement is based on a contribution supplement table approved by the KTRS Board of Trustees. The retired member pays premiums in excess of the monthly supplement. The Commonwealth of Kentucky bears no risk for excess claims expenses that exceed the premium equivalents charged for the Kentucky Employees Health Plan. Once retired members and eligible spouses attain age 65 and are Medicare eligible, coverage is obtained through the KTRS Medicare Eligible Health Plan. KTRS bears the risk for actual drug claims cost in the Medicare Eligible Health Plan.

At June 30, 2007, KTRS insurance covered 31,642 retirees and 6,674 dependents. There are 198 participating employers and 75,144 active members contributing to the Medical Insurance Fund.

**B. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

**Basis of Accounting**

The Medical Insurance Plan financial statements are prepared using the accrual basis of accounting. Member contributions and employer matching are recognized in the fiscal year due. Healthcare premiums charged to retired members are recognized when due and any premiums collected in advance are recognized as a liability.

**Method Used to Value Investments**

Since the investments are all short-term investments they are reported at cost, which approximates fair value.

Note 8: Medical Insurance Plan & Post-Employment Benefits continued . . .

### **C. CONTRIBUTIONS**

The post-retirement healthcare provided by KTRS is financed on a pay-as-you-go basis. In order to fund the post-retirement healthcare benefit, one and five tenths percent (1.5%) of the gross annual payroll of all active members is contributed. One-half (1/2) of this amount is derived from member contributions and one-half (1/2) from state appropriation. Also, the premiums collected from retirees as described in the plan description and investment interest help meet the medical expenses of the plan.

Skyrocketing medical expenses have made it increasingly difficult to meet the expenses of the retiree health insurance program. To further fund the plan, the state legislature has directed a portion of the state employer contribution in a sufficient amount to be allocated to the Medical Insurance Fund instead of the pension fund. The system actuary calculated those amounts to be \$85,000,000 and \$125,000,000 for fiscal years 2007 and 2008 respectively. Funds allocated to KTRS from the general fund for the fiscal year ended June 30, 2007 reduced the \$85 million allocation to \$73 million. The remaining balances are to be amortized over a period of 10 years. The Legislature appropriated \$14,133,200 in the fiscal year 2007-2008 to apply to amortization of the balances.

### **D. FUNDED STATUS AND FUNDING PROGRESS**

The funded status of the Medical Insurance Plan as of the most recent actuarial valuation date is as follows (dollar amounts in 1,000's):

Valuation Year June 30	Actuarial Value of Assets	Actuarial Accrued Liabilities	Unfunded Actuarial Accrued Liabilities (uaal)	Funded Ratio	Covered Payroll	UAAL as a % of Covered Payroll
	A	B	B-A	(A/B)	C	[(B-A)/C]
2007	\$140,772	\$5,928,761	\$5,787,989	2.4%	\$2,975,289	194.5%

Actuarial valuations of an ongoing plan involve estimates of the value of reported amounts and assumptions about the probability of occurrence of events far into the future. Examples include assumptions about future employment, mortality, and the healthcare cost trend. Actuarially determined amounts are subject to continual revision as actual results are compared with past expectations and new estimates are made about the future. The schedules of funding progress, presented as required supplementary information following the notes to the financial statements, present multiyear trend information about whether the actuarial values of plan assets are increasing or decreasing over time relative to the actuarial accrued liabilities for benefits.

The accompanying schedule of employer contributions present trend information about the amounts contributed to the plan by employers in comparison to the ARC, an amount that is actuarially determined in accordance with the parameters of GASB Statement 43. The ARC represents a level of funding that, if paid on an ongoing basis, is projected to cover

Note 8: Medical Insurance Plan & Post-Employment Benefits continued . . .

normal cost for each year and amortize any unfunded actuarial liabilities (or funding excess) over a period not to exceed thirty years.

Projections of benefits for financial reporting purposes are based on the substantive plan (the plan as understood by the employer and plan members) and include the types of benefits provided at the time of each valuation and the historical pattern of sharing of benefit costs between the employer and plan members to that point. The actuarial methods and assumptions used include techniques that are designed to reduce the effects of short-term volatility in actuarial accrued liabilities and the actuarial value of assets, consistent with the long-term perspective of the calculations.

Significant actuarial methodologies and assumptions employed as of the June 30, 2007 valuation date include the following:

Actuarial cost method	Projected unit credit
Actuarial value of assets	Market value of assets
Assumed inflation rate	4.0%
Investment rate of return	4.5%
Projected salary increases	4.0%
Amortization method	Level percent of pay, open
Remaining amortization period	30 years
Healthcare trend rate	12.00%
Ultimate trend rate	5.00%
Year of Ultimate Pre-Medicare trend rate	2015

## **E. INCURRED BUT NOT REPORTED CLAIMS LIABILITIES**

KTRS recognizes estimates of liabilities for self-insured unpaid claims that have incurred (both reported and unreported) using the development method. This method uses past observed patterns of time between the date the claim is incurred and the date the claim is paid to estimate incurred claims from available paid claim information. The following schedule shows the change in the claims and liability and the claims activity for the years ended June 30, 2007 and 2006.

	<b>Fiscal Year 2007</b>	<b>Fiscal Year 2006</b>
Beginning Unpaid Claims Liability	\$ 7,580,738	\$ 8,312,898
Claims Incurred	174,350,593	166,148,844
Current Year	(4,847,798)	(1,142,811)
Increase (Decrease) in Prior Years		
Total Incurred Claims	\$ 169,502,794	\$ 165,006,034
Claims Paid		
Current Year	\$ 169,765,533	\$ 160,549,717
Prior Years	5,351,852	5,188,476
Total Payments	\$ 175,117,385	\$ 165,738,193
Ending Unpaid Claims Liability	\$ 1,966,148	\$ 7,580,738

**Required Supplementary Schedules**

**Required Supplemental Schedule  
Defined Benefit Plan  
Schedule of Funding Progress  
(dollar amounts in millions)**

VALUATION YEAR JUNE 30	ACTUARIAL VALUE OF ASSETS	ACTUARIAL ACCRUED LIABILITIES	UNFUNDED ACTUARIAL ACCRUED LIABILITIES (UAAL)	FUNDED RATIO	COVERED PAYROLL	UAAL AS A % OF COVERED PAYROLL
	a	b	(b-a)	(a/b)	c	[(b-a)/c]
2002	\$13,588.8	\$ 15,695.6	\$ 2,106.8	86.6%	\$2,313.7	91.1%
2003	13,863.8	16,594.8	2,731.0	83.5	2,497.7	109.3
2004	14,255.1	17,617.6	3,362.5	80.8	2,641.5	127.3
2005	14,598.8	19,134.8	4,536.0	76.3	2,703.4	167.8
2006	14,857.6	20,324.7	5,467.1	73.1	2,859.5	191.2
2007	15,285.0	21,255.0	5,970.0	71.9	2,975.3	200.7

The amounts reported in this schedule of funding progress do not include assets or liabilities for post-employment healthcare benefits, nor are the assets and liabilities of the tax-sheltered annuity plan included.

**Required Supplemental Schedule  
Defined Benefit Plan  
Schedule of Employer Contributions  
(dollar amounts in millions)**

FISCAL YEAR ENDED JUNE 30	ANNUAL REQUIRED CONTRIBUTIONS	PERCENTAGE CONTRIBUTED
2002	\$ 284,794,710	100 %
2003	322,046,968	100
2004	364,351,412	100
2005	383,776,826	100
2006	406,107,266	100
2007	494,565,369	85

**Required Supplemental Schedule  
Medical Insurance Plan  
Schedule of Funding Progress**  
(dollar amounts in millions)

VALUATION YEAR JUNE 30	ACTUARIAL VALUE OF ASSETS	ACTUARIAL ACCRUED LIABILITIES	UNFUNDED ACTUARIAL ACCRUED LIABILITIES (UAAL)	FUNDED RATIO	COVERED PAYROLL	UAAL AS A % OF COVERED PAYROLL
	a	b	(b-a)	(a/b)	c	[(b-a)/c]
2005	\$ 147.3	4,763.9	\$ 4,616.6	3.1 %	\$ 2,703.4	170.8%
2006	131.6	4,341.9	4,210.3	3.0	2,859.5	147.2
2007	140.8	5,928.8	5,788.0	2.4	2,975.3	194.5

The amounts reported in this schedule of funding progress do not include assets or liabilities for the defined benefit plan, nor are the assets and liabilities of the tax-sheltered annuity plan included.

**Required Supplemental Schedule  
Medical Insurance Plan  
Schedule of Contributions from Employers and Other Contributing Entities**

Fiscal Year Ending Date	Annual Required Contribution (ARC) (a)	Actual Employer Contribution (b)	Retiree Drug Subsidy Contribution (c)	Total Contribution (b) + (c)	Percentage of ARC Contributed (b) + (c)
6/30/2007	\$231,473,321	\$113,258,761	\$10,312,361	\$123,571,122	53.40%

*Only one year of actuarial calculations of annual required contributions is available.*

**Supporting Schedule 1**  
Schedule of Administrative Expenses  
Year Ended June 30, 2007

Salaries	\$ 5,185,438
Other Personnel Costs	490,087
Professional Services & Contracts	289,581
Utilities	71,728
Rentals	13,564
Maintenance	64,315
Postage & Related Services	345,574
Printing	149,473
Insurance	93,732
Miscellaneous Services	94,097
Telecommunications	27,239
Computer Services	34,953
Computer & Software Maintenance	113,320
Supplies	53,604
Depreciation	106,897
Travel	42,966
Dues & Subscriptions	33,318
Miscellaneous Commodities	10,208
Furniture, Fixtures, & Equipment not Capitalized	96,686
Compensated Absences	35,066
<b>TOTAL ADMINISTRATIVE EXPENSES</b>	<b>\$ 7,351,846</b>

## Supporting Schedule 2

Schedule of Investment Expenses  
(Contracted and Non-Contracted)  
Year Ended June 30, 2007

<b>BALANCED MANAGER</b>		
Todd Investment Advisors		\$ 1,285,000
<b>FIXED INCOME MANAGERS</b>		
Galliard Capital Management		288,002
<b>EQUITY MANAGERS</b>		
GE Asset Management Inc.	\$ 800,000	
UBS Global Asset Management Corporation	2,655,658	
Wellington Management Company,LLP	<u>2,730,000</u>	
<b>Total Equity Managers</b>		6,185,658
<b>CUSTODIAN</b>		
Farmers Bank		517,199
<b>PRIVATE EQUITY</b>		
Kolberg Kravis Roberts Company		317,566
<b>CONSULTANT</b>		
Becker, Burke Associates		<u>65,000</u>
<b>TOTAL CONTRACTED INVESTMENT MANAGEMENT EXPENSES</b>		8,658,425
<b>OTHER</b>		
Misc Investment Expenses (noncontracted)		<u>9,244</u>
<b>TOTAL INVESTMENT EXPENSES</b>		<u><u>\$ 8,667,669</u></u>

## Supporting Schedule 3

Schedule of Professional Fees for Year Ended June 30, 2007

PROFESSIONAL	NATURE OF SERVICE	YEAR ENDED JUNE 30, 2007
Charles T. Mitchell Company, LLP	Auditing Services	\$ 28,000
Cavanaugh Macdonald Consulting	Actuarial Services	232,380
Reed, Weitkamp, Schell & Vice, PLLC	Attorney Services	3,431
Office of Kentucky Attorney General	Attorney Services	1,669
Farmers Bank	Banking Services	15,820
International Claim Specialist	Investigative Services	<u>8,281</u>
	<b>TOTAL</b>	<u><u>\$ 289,581</u></u>



*Charles T. Mitchell Co. LLP*  
Certified Public Accountants

*William G. Johnson, Jr., C.P.A.*  
*James Clouse, C.P.A.*  
*Bernadette Smith, C.P.A.*  
*Kim Field, C.P.A.*  
*Greg Miklavcic, C.P.A.*  
*Don C. Giles, C.P.A., Consulaant*

**REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND ON COMPLIANCE AND OTHER MATTERS  
BASED ON AN AUDIT OF FINANCIAL STATEMENTS PERFORMED IN ACCORDANCE WITH  
GOVERNMENT AUDITING STANDARDS**

Board of Trustees

Teachers' Retirement System of the State of Kentucky

Frankfort, Kentucky

We have audited the general purpose financial statements of the Teachers' Retirement System of the State of Kentucky, a component unit of the Commonwealth of Kentucky, as of and for the year ended June 30, 2007, and have issued our report thereon dated December 5, 2007. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in Government Auditing Standards, issued by the Comptroller General of the United States.

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Teachers' Retirement System of the State of Kentucky's internal control over financial reporting as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Teachers' Retirement System of the State of Kentucky's internal control over financial reporting. Accordingly, we do not express an opinion on the effectiveness of the Teachers' Retirement System of the State of Kentucky's internal control over financial reporting.

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the entity's ability to initiate, authorize, record, process, or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected by the entity's internal control.

A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected by the entity's internal control.

Our consideration of internal control over financial reporting was for the limited purpose described in the first paragraph of this section and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. We did not identify any deficiencies in internal control over financial reporting that we consider to be material weaknesses, as defined above.

Compliance and Other Matters

As part of obtaining reasonable assurance about whether Teachers' Retirement System of the State of Kentucky's financial statements are free of material misstatements, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grant agreements, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance or other matters that are required to be reported under Government Auditing Standards.

This report is intended solely for the information and use of management and the Commonwealth of Kentucky and is not intended to be and should not be used by anyone other than these specified parties. However, this report is a matter of public record and its distribution is not limited.

*Charles T. Mitchell Co.*

Frankfort, Kentucky  
December 5, 2007

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